THE INCOME TAX LAW AND DEDUCTION AT THE SOURCE.

The national Income Tax Law under which we now live comprises the second section of the Revenue Act of October 3, 1913. Like its predecessor of 1894,[1] whose existence was cut short by the Supreme Court's decision that it imposed a direct tax, and, not apportioning such tax among the States as required by the Constitution, was, therefore, void,[2] the present law formed part of an act which substantially lowered the existing tariff. The party in power, having reduced the duties upon imports into the United States, felt that it was necessary to meet from some other source of taxation the deficit which would otherwise follow. For this purpose it had the choice between an income tax and stamp duties. The latter form of taxation is popularly considered as a "war tax," or method of meeting the expense of armament; but as a matter of fact the income tax has equally been resorted to as a means to that end. During the Civil War the United States Government imposed an income tax in addition to stamp duties, and the early English Income Tax Law of 1806[3] was, by its terms, to last only until the conclusion of the Napoleonic wars. Congress, however, relegated stamp duties to second choice as a means of meeting the present situation, and hence the second section of the General Revenue Law lays upon us an income tax.

The introduction of a bill for this Act into the House narrowly succeeded in point of time the adoption by the last requisite State of the Sixteenth Amendment to the Constitution which justified the proposed measure. As the last State ratified the amendment as late as February of the current year, Congress enacted that for the present year the income should be computed only from March 1st to December 31st, and that correspondingly only five-sixths of the allowable deductions for the year 1913 should be made.

The scheme of taxation embodied in the Act, as we read it, is substantially as follows: The tax is upon the income received during the whole of a year (with the exception of the year 1913,

[1] Act Aug. 27, 1894, c. 349, §§ 27-37.

[2] Pollock *v.* Farmers Loan & Trust Co. (1895) 157 U. S. 429, 158 U. S. 601.

[3] 46 Geo. III, c. 65.

as to which only ten months shall be taken). The income shall be computed for the calendar year in the case of individuals and partnerships. In the case of corporations more latitude is allowed, the Act providing that any such company may designate the last day of any month in the year as closing its fiscal year and shall be entitled to have the tax computed on the income of the period thus constituted. In the case of an individual and any corporation whose fiscal year is the calendar year, a return shall be made to the collector between the first of the year and the first of March in the succeeding year. In the case of a corporation whose fiscal year does not coincide with the calendar year, a return shall be made within sixty days after the close of its fiscal year.

Circumstances have forced the general public, as well as the Treasury Department, to face at once the new law's most salient, if not its most popular feature, the so-called system of collection at the source. Upon this subject the Treasury Department has issued two sets of Regulations, all confined to this single phase of the Statute. In brief, Congress adopted the scheme of taxation at the source which has been used in England for a number of years; the idea being that if one person pays to another by way of interest, rent or other fixed charge, an annual or periodical amount, the debtor shall deduct and turn over to the Government the amount requisite to cover what is described in the Statute as the normal income tax. The system of taxation at the source is only concerned with this normal tax; the increasing scale of super tax, provided for by the Statute with respect to income exceeding twenty thousand dollars per annum and upward, not being collectible by means of this process.

The Act was signed in the evening of the third day of October, and provided that the system of deduction at the source should commence with payments stipulated to be due on the first day of the following month. Thus less than thirty days was permitted to the Treasury Department to construe the law, accustom itself to a scheme of taxation with which the oldest living man was scarcely familiar, and prepare the necessary machinery for carrying into effect the provisions of the Act. It must be remembered that on the first day of every month thousands of dollars of interest is paid by debtors in one form or another to their creditors in this country, and the first day of November is a favorite stipulated time for the payment of semi-annual or quarterly interest. The Act provided no method for collecting the tax at the source, except to

direct in the most unequivocal terms that it should be deducted, and it was for the Treasury Department to provide the necessary machinery.

The Department's labors, thus entailed, resulted in the first set of Regulations, dated October 25, 1913, "regarding the deduction of the income tax at the source on interest maturing on bonds, notes and other similar obligations of corporations, joint stock companies or associations, and insurance companies." Under these Regulations the banks and trust companies all over the country which, whether as paying agents for corporations in meeting the interest upon their bonded indebtedness, or, as agents for their customers, in collecting this interest, managed to arrange their operations in connection with the great quantity of interest coupons that fell due on the first of November. The Treasury followed this set of Regulations with another set dated October 31, 1913, "regarding the deduction of the income tax at the source on income other than interest maturing on bonds, notes, and other similar obligations of corporations, joint-stock companies or associations, and insurance companies."

In effect, therefore, the Treasury has, under the Statute, issued Regulations regarding the deduction of the tax at the source, which, in two grand divisions, relate to (a) the bonds, notes, and similar obligations of corporations, and (b) other cases of fixed annual or periodical income, such as salaries, rent, income from trust estates, and the like.

These Regulations are entitled to more than ordinary interest as well as attention, because not only is the Act very obscure in many places, but, unlike the English statutes on the same subject, it wholly abstains from prescribing details of procedure. In brief, it imposes a tax, of a kind which is unfamiliar to the public, and it leaves to the executive branch of the Government not only the task of working out all details of collecting the tax, but the even more onerous duty of construing the Act in order to prepare a scheme of collection. Thus the Regulations not alone contain a comprehensive plan for collecting the tax at the source, as required by the Statute, but they bear evidence of a theory of the Act's meaning which the Treasury must have felt compelled to formulate if there were to be any regulations at all. There was no time to make test cases for the courts; the course must be set by a dead reckoning. As furnishing an interpretation of the Statute these Regulations are entitled, therefore, to great weight, apart from their intrinsic binding effect, and it is from this point of view that they

should be chiefly regarded. In considering the possible interpretation the courts may eventually give to the Statute, the importance of the Regulations is manifest, for it is an old principle that the contemporaneous construction of a statute by that branch of the Government upon which is imposed the duty of executing its provisions, is not only entitled to much consideration, but "in a case of doubt ought to turn the scale."[3a]

The first question that must have arisen in framing these Regulations was, what is the "source" meant by the Statute? In the case of foreign income, that is, income payable to residents or citizens of this country by foreign debtors, all the Regulations had to do was to follow the Act in requiring the first domestic bank handling the check representing interest payment to deduct the tax. But with regard to the income received from domestic debtors, the Act was not at all clear. It provides as follows:

> "All persons, etc., in whatever capacity acting, *having the control, receipt, disposal, or payment* of fixed or determinable annual or periodical gains, profits, and income of another person subject to tax, shall in behalf of such person deduct and withhold from the payment an amount equivalent to the normal income tax upon the same," etc.[4]

Take, under this language, the common case of a trust estate which owns bonds of a railroad company. The trustee, prior to the first of November clips the interest coupons maturing on that date and deposits them with his bank for collection. This bank in turn sends the coupons to its correspondent bank in the city where the corporation's fiscal agent is, and that bank in turn presents the coupons to the fiscal agent. The coupons are paid by the fiscal agent, the money is then transmitted through the chain of collecting banks to the bank where the coupons were first deposited, and in turn that bank honors the check of the trustee for the amount of the coupons. The trustee, thus having by means of this process obtained the face value of the coupons in money, turns it over to his *cestui que trust*. Now within the literal language of the Statute each of those persons,—the trustee, his bank, its correspondent bank, the fiscal agent of the corporation and the debtor corporation itself, —is subject to the duty of withholding the normal tax, because in one form or another each one of them has had either the control, receipt, disposal or payment of the interest money which represents

[3a]Brown *v.* United States (1884) 113 U. S. 568; Edwards' Lessee *v.* Darby (1827) 12 Wheat. 206; United States *v.* Hill (1887) 120 U. S. 169.

[4]Paragraph D.

the income of the *cestui que trust.* Therefore, while the Act probably could not be construed as requiring each person in the line to deduct the tax, yet it might have been construed as making each of these persons liable as surety for the others, so that no matter which one of them deducts the tax the others are bound to see to it that he pays the money over to the Government.

This, of course, would be a hardship, resulting as it would in imposing eventually upon thousands of persons over the country,—banks, trustees, trust companies and what not,—the liability for thousands of other people in different parts of the country paying to the government the normal tax on money which had passed through their hands at one time or the other during the year. It was, therefore, reasonably within the power of the Treasury Department, in framing its Regulations, to pick out which one of such a chain of persons should be the one to deduct the tax and to whom the Government would look. That the Treasury Department did, and its action in this respect is to be highly commended, for it removed what otherwise would have been a source of great uncertainty if not of positive injustice.

The Regulations are very clear in this respect. The first set, relating to the interest upon bonded indebtedness, provide that "for the purpose of collecting this tax on all coupons and registered interest originating or payable in the United States the source shall be the debtor (or its paying agent in the United States), which shall deduct the tax when same is to be withheld, and no other bank, trust company, banking firm or individual taking coupons or interest orders for collection or otherwise shall withhold the tax thereon." Those of October 31st, relating to rent, etc., also provide that "the normal tax * * * shall be deducted and withheld *at the source,* and payment made to the Collector * * * by the Debtor or his * * * agent authorized to make such deduction or payment," and no subsequent handler of the funds shall be required to again deduct the tax.

The Regulations of October 25th prescribe only one condition to this relief of the subsequent fiduciary. In the case of interest on corporate bonded indebtedness, the subsequent fiduciary must see to it that when the debtor corporation pays the interest, it shall get a certificate of ownership signed by the owner of the bonds upon which the interest matured, otherwise the collecting fiduciary shall itself deduct the tax and deliver to the debtor corporation its own certificate, showing the fact of such deduction, and the name and address of the bondholder or of the person presenting the cou-

pons if the owner is not known. Thereupon the debtor corporation shall not again withhold the tax, but in lieu thereof shall deliver to the Government the certificate of the collecting bank. Thus the collecting bank can relieve itself of this burden of deduction by procuring from the real owner of the bonds, for whom it is acting, a certificate of ownership which finally reaches the Government by way of the debtor corporation.

Each certificate is to be signed by the person who is the actual or beneficial owner of the bonds from which the coupons were detached and must show whether that person claims to be exempt from the deduction of the tax. For instance, if the owner of the bonds is a non-resident alien or a corporation, that fact should be stated and thereupon the tax may not be deducted. If the owner of the bonds is an individual he should state that fact and then should state whether or not he claims the benefit of any of the exemptions and deductions allowed by the Act.

Two classes of coupon-holders these Regulations declare to be exempt from deduction at the source, corporations and non-resident aliens. Corporations are exempt from this method of collection on any kind of income by the plain meaning of the Statute, because its first paragraphs[5] relate to *persons* and in these paragraphs is included the scheme of deduction at the source, while the imposition of the tax upon the incomes of business corporations, joint stock companies and associations, and insurance companies, is covered by the paragraphs following,[6] which provide no such method. The Excise Tax Law of 1909,[7] which, while in effect imposing a tax upon the income of corporations, escaped the fate of the Income Tax Law of 1894 by being construed as an excise tax upon the business conducted by corporations (and not a tax upon the income of the shareholders)[8] worked so well that the framers of the present Act were apparently satisfied that the Government would receive its just due upon the incomes of corporations without requiring persons indebted to them to deduct the tax at the source. For the like reason there is no income tax upon the dividends from the stock of domestic corporations.

Non-resident aliens are exempt from taxation upon corporate bonds held by them, because under an opinion rendered by the Attorney General to the Treasury Department, such persons do not

[5] A to F, inclusive.

[6] Paragraphs G *et seq.*

[7] Sixty-first Congress, 1st Sess. (1909) c. 6, § 38.

[8] Flint *v.* Stone Tracy Co. (1911) 220 U. S. 107.

derive their income from "property owned within the United States" or a "business, trade or profession carried on in the United States" under Paragraph A of the Statute.[9] Of course, such persons are taxable upon income derived from any of the sources thus described in the paragraph, such as rent, etc., and such tax is subject to collection at the source.

Here we should speak of the exemptions and deductions allowed to an individual (and as we have seen, an individual as distinct from a corporation is the only person who is subject to taxation at the source).[10] The Act provides that no person having a net income of less than $3,000 shall be subject to the tax.[11] In this respect the exemption allowed is far greater than in England, and a great deal may be said for and against this high exemption allowed by our Statute, but this is no place for such a discussion. In the case of a married man living with his wife, $1,000 additional exemption is allowed. If the gross income of a person exceeds this sum then he is allowed the deductions prescribed by Paragraph B of the Act, such as losses incurred in trade, etc. When he has made these deductions then he has his net income available for taxation, and if that net income does not exceed $3,000 (or $4,000 in the case of a married man) he is not a taxable person. If it exceeds $3,000 (or $4,000) he is a taxable person to the extent of such excess.

All the regulations require of such a person is that he state (a) his ownership of the bonds from which the coupons were detached and (b) whether or not he then does or does not claim exemption, the language provided in this respect being "I do (I do not) now claim, with respect to the income represented by said interest, the benefit of the deductions," etc. The word *"now"* is important. This deduction at the source occurs during the calendar year, and it may very well be that an individual at the time he makes his certificate cannot say definitely whether or not he claims his exemption because he cannot tell how his income will foot up

[9]A conclusion eminently sound, as the decision in State Tax on Foreign Held Bonds (1872) 15 Wall. 300, though limited, has never been overruled. Certainly the language of the Statute should not be stretched to cover a class of persons not directly within its plain meaning. United States *v.* Isham (1873) 17 Wall. 496. An intention to tax a thing which does not exist within the jurisdiction should not be imputed to a legislative body. Board of Assessors *v.* N. Y. Life Ins. Co. (1910) 216 U. S. 517.

[10]Partnerships are plainly treated by the Act according to the common law conception, as associations of individuals, and are consequently, as the Act provides, not separately taxable as to partnership assets.

[11]Paragraph D.

at the close of the year. Consequently the object of the word "now" evidently is to prevent any unjust estoppel upon the taxpayer, or force him to any unjust election, so that when he settles with the collector after the first of the year he can claim exemption despite a previous abjuration.

The Regulations require that such a certificate accompany the coupons, and are mandatory to that effect. Consequently, no debtor corporation, in the writer's opinion, can safely afford to pay even negotiable interest coupons without exacting a certificate from the coupon-holder if he presents them in person or through a messenger. If, on the other hand, he presents them by means of a collecting bank then the Regulations are clear in a proviso that if the coupons are not accompanied by certificates, the "first bank * * * receiving the coupons * * * shall deduct and withhold the tax and shall attach to such coupons or interest orders its own certificate, giving the name and address of the owner * * * with a description of the coupons * * * also setting forth the fact that they are withholding the tax upon them." So in either case the upshot of the matter is that the Government gets information as to the owner of the income represented by the coupons.

The Regulations of October 31, 1913, also make compulsory the filing of a certificate. They provide:

"Any person subject to the normal tax * * * wishing to avail himself or herself of the exemption * * * must file with the withholding agent, not later than 30 days prior to the day on which the return of his income is due, a notice," etc.

These Regulations also take into account the chain of liability which we have mentioned by providing that the debtor corporation shall be the source; and that no other person having the receipt, custody or disposal of income shall again deduct the tax, provided that any such person, other than the debtor who has withheld the tax, shall file with the collector a certificate showing that the tax has already been withheld. The same requirement is made with respect to foreign income. The first bank handling the check representing the income received from a foreign debtor must require a certificate of ownership. Thus in every case of deduction at the source the Government ends by not only getting the tax, but by knowing whom it is taxing.

Whether the Government had a right to thus exact certificates of ownership is at least a speculative question. Whether it will ever be a practical question is another matter. It is probable that any citizen or resident of this country would hesitate to "bell the

cat" by claiming in the open his right to remain in the dark. The Regulations, however, may not continue without some changes. The Department for instance, will have to deal with a certain class of non-resident alien bondholders. Unlike the custom prevailing in America, it is on the Continent of Europe a common practice to discount and trade in coupons detached from bonds so that it may be impossible for a discounting bank to certify as to the ownership of the bonds from which its purchased coupons were detached, or obtain certificates of ownership for the Government. In this class of cases, where the probability is strong that none of the coupons come from bonds owned by taxable persons, it is submitted that the Government can afford to relax the rigor of its present Regulations. Likewise the suggestion has been made that the Department amend its Regulations so as to allow by some means or other all certificates of ownership of coupons to go directly to the Treasury Department instead of passing through the hands of the debtor corporation. But no such modifications, if made, would affect the principle which the Department has laid down in the present Regulations, that the Government is entitled to know the ownership of incomes so that it may be in a better position to enforce the provisions of the Act taxing incomes.

Has the Department the power to exact such information from either the creditor who presents his claim for interest, or the debtor who pays it? That question we shall now consider as it is presented by the present Regulations, which require the debtor to obtain this information and furnish it to the Government. This raises the whole issue, because if the Government has the right to exact information from the debtor, it follows that it has the like power to extort it directly from the creditor, should it later decide to relieve the debtor from this burden. So the question is, are the present Regulations lawful?

Treasury Regulations can only have the force of law where the Statute points out an object to be gained, but fails to provide the particular mode for obtaining it; on the other hand if the Statute is express to one effect, the Regulations cannot provide to the contrary.[12]

In the present case the Statute seems fairly express in giving the bondholder an option. He may file a claim of exemption with his debtor at the time he receives his interest or he may let the tax be deducted thereon, and after the first of the year, claim his exemp-

[12]Campbell *v.* United States (1882) 107 U. S. 407.

tion when he makes his personal return to the collector.[13] In addition the Statute[14] requires the debtor, after deducting the tax, to "make and render a return * * * of the portion of the income of each person from which the normal tax has been thus withheld, *and containing also the name and address of such person or stating that the name and address or the address, as the case may be, are unknown,*" thus contemplating a case where a negotiable interest obligation which is payable to bearer, such as a coupon, is presented over the counter and the debtor corporation does not know who is the owner. The effect of the Regulations is to deprive all interest certificates of such negotiability as they may have formerly possessed by being payable to bearer, for now the bearer must disclose his identity.

On the other hand, this may be said in behalf of the Regulations: They afford a convenient method for the debtor to ascertain the bondholder's name and address, so that it will not be necessary to make a return stating that the name and address are unknown. Also, while the creditor under the Statute is given an option to file his claim of exemption with the debtor corporation, the Regulations do not conflict with that because they require, not a positive claim of exemption, but simply, by the use of the word "now" which we have above discussed, a tentative claim. So, in effect, it may be argued that the Regulations do not contradict any express provision of the Statute; although of course they do not carry out any express provision of the Statute.

But it would seem that their justification may be placed on a broader ground, which is this:

The system of deduction at the source is not the whole of the income tax scheme. The Act requires all taxable persons after the close of the current year to make a return to the collector of each district showing the net amount of income available for taxation, and it gives the collector the right to require returns from any person subject to the tax. We might as well face the fact that the Government cannot go very far with taxation of incomes without being forced to adopt an inquisitorial system for discovering objects of taxation. The income of a person is even more easily secreted than his personal property. If he can hide the physical evidences of the principal amount of his debt, it is all the more easy to hide the fact that he is receiving income therefrom. It follows that any Government which institutes an income tax must

[13]Paragraph E.
[14]Paragraph D.

also be prepared to adopt a system of espionage which may at first seem shocking.

In England all this is recognized. The income tax "is more than any other form of taxation, liable to evasion," is always unpopular, and is "inquisitorial in the last degree."[15] The Government, in its attempts to ferret out taxable incomes has recently, if we may trust the writer last cited, even attempted to make solicitors betray confidential communications from their clients.[16] And curiously enough, we find frequent complaint of a practice which has become common with English assessors, arbitrarily to raise a man's assessment so that, on his application for a reduction, he may be forced to disclose the real state of his affairs, which is identical with the time honored custom in the City of New York in regard to the personal property tax.

What in effect has happened with us is that the Treasury Department has seized upon this method of deduction at the source as a means of getting information as to the number of people in this country who are subject to the income tax. The Treasury was evidently moved by the thought that if a man has an income he is worth watching. While his taxable income may not exceed $3,000 this year, still he is probably the type of man whose income will exceed $3,000 in the course of a year or so, and it is well to keep an eye on him and his future. Consequently, the Department has required these certificates, and the justification for its action in this respect must be placed on the broad ground that by adopting an income tax at all, Congress impliedly conferred upon the Treasury Department the power by every means within the scope of the Act, to exact information as to the incomes within this country that are subject to taxation.

This particular method of inquisition could not be adopted in England because there the theory of deduction at the source fundamentally differs from that which appears in our Statute. In the first place there is no method by which the creditor can claim exemption by means of notice to the debtor; the latter deducts the tax as a matter of course, and the creditor can claim a refund only from the Government. In England, wherever there is a "source" the statute imposes the tax there,—it taxes the debtor, requires him to pay it, and then, to shift the ultimate burden upon the creditor, provides that the latter shall accept the deduction as part payment upon the debt. Such a deduction therefore, may be so pleaded to

[15]Jarvis, Income Tax, London, 1912, pp. xxiv, 80.
[16]*Op. cit.*, 95-7.

an action for the debt.[17] The theory in England always has been that such a deduction is, from all points of view, a payment on account of the debt, the statute interposing the Government as assignee of the debt *pro tanto*.[18]

Our statute, on the contrary, lays the tax directly upon the creditor, and imposes upon the debtor the duty of deducting it from the interest payment. As the Supreme Court has said:

> "It is no pecuniary burden upon the corporation, and no taxation of the corporation. The burden falls on the creditor. He is the party taxed."[19]

In the words of Mr. Justice Field, the debtor "is thus made the agent of the Government for the collection of the tax."[20] The power of a government, whether State or Federal, to impose such a duty upon the citizen, has been upheld by the Supreme Court.[21]

In plain words, the Statute is express in imposing upon the debtor citizen the duty of collecting, by means of deduction from interest payments, the tax upon his creditor's income. The Regulations have laid upon this citizen turned tax gatherer the additional duty of collecting from the creditor a statement identifying himself as such.

If the Government can impose the one duty upon the private citizen, that of being its tax collector without compensation, it is but a step further to impose the other duty, being its census gatherer. That step the Regulations have taken. Whether the ingenuity of the process is in inverse ratio to its legality is a question for the future; but not, it would seem, a very serious question.

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[17]Tinckler *v.* Prentice (1812) 4 Taunt. 549; Franklin *v.* Carter (1845) 1 C. B. 750.

[18]*Re* Sturmey Motors Ltd. L. R. [1913] 1 Ch. 16. It follows that while a tenant can recover the amount paid for the tax on the common counts if the landlord, disregarding the fact of the deduction, has evicted him for non-payment of the rent in full, Graham *v.* Tate (1813) 1 M. & S. 609, he cannot sue the landlord on the common counts for money paid on account of the tax, if he has paid the rent next accruing in full, without deduction. Denby *v.* Moore (1817) 1 B. & Ald. 123; Cumming *v.* Bedborough (1846) 15 M. & W. 438; Spencer *v.* Parry (1835) 3 Ad. & El. 331. The point is thus put by Platt, B: "This tax is assessed upon the occupier; he is bound to pay it; and the tenant's remedy is to recompense himself out of the next rent. The money paid by him for the tax is paid in part satisfaction of the rent; and how can money paid in part satisfaction of the rent, be paid to the use of the landlord?" Cumming *v.* Bedborough, *supra.*

[19]United States *v.* B. & O. R. R. (1872) 17 Wall. 322.

[20]United States *v.* Erie R. R. Co. (1882) 106 U. S. 327, 331.

[21]United States *v.* B. & O. R. R., *supra;* First Nat. Bank *v.* Kentucky (1869) 9 Wall. 353; Cumming *v.* Merchants Nat. Bank (1879) 101 U. S. 153.

Undoubtedly, if left undisturbed, this plan is bound to achieve its purpose of getting revenue for the Government. And if it should ever be judicially determined that the Regulations are not justified by the Statute, then it would be better to amend the Statute than to do without the Regulations, if the Government desires that the Statute should fulfill its purpose of producing revenue.

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